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IN FOCUS

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The 3.8% Net Investment Income Tax: Overview, Data, and Policy Options

Since 2013, certain higher-income individuals have been subject to a 3.8% "unearned income Medicare contribution" tax, more commonly referred to as the net investment income tax (NIIT). The statutory authority for the tax is included in Internal Revenue Code Section 1411. The tax was included as a revenue-raising offset in the Health Care and Education Reconciliation Act of 2010 (HCERA, P.L. 111-152), shortly after the Patient Protection and Affordable Care Act (P.L. 111-148) was signed into law. These two laws are commonly referred to as the Affordable Care Act or ACA.

Policymakers may consider modifications to the NIIT to raise revenue, address income inequality concerns, or both. Repeal of the NIIT is also a policy option. This In Focus provides an overview of the tax, presents data on the distribution of the tax, and considers several policy options.

Overview of the NIIT

The NIIT is equal to 3.8% of the net investment income of individuals, estates, and certain trusts. Net investment income includes interest, dividends, annuities, royalties, certain rents, and certain other passive business income not subject to the corporate tax. Net investment income also includes the amount of capital gain resulting from a home sale that exceeds the amount that can be excluded from taxation ($200,000 for single, $500,000 for married filed jointly). Net investment income does not include wages, unemployment compensation, nonpassive business income, Social Security Benefits, alimony, tax-exempt interest, and distributions from some tax-preferred retirement accounts; for example, 401(k)s, 403(b)s, and 457(b)s.

The tax applies to taxpayers with modified adjusted gross income (MAGI) in excess of $200,000 if single or head of household and $250,000 if married filing jointly ($125,000 for married filing separately). The income thresholds are not adjusted annually for inflation. For taxpayers without foreign-source income, MAGI generally equals adjusted gross income (AGI). Hence, MAGI includes wages, salaries, tips, and other compensation; dividend and interest income; business and farm income; realized capital gains; retirement distributions; and income from a variety of other passive activities and certain foreign-earned income.

For those subject to the NIIT, the amount of tax owed is equal to 3.8% multiplied by the lesser of

- net investment income, or
- the amount by which their MAGI exceeds $200,000/$250,000.

Who Pays the NIIT?

The Joint Committee on Taxation (JCT) estimates that the NIIT will raise approximately $27.5 billion of tax revenue in 2021. According to the most recent data from the Internal Revenue Service, the majority of the tax is paid by higher-income households. This reflects the fact that the tax only applies to those taxpayers with income (MAGI) above $200,000 if single or head of household and $250,000 if married filing jointly.

Table 1 shows taxpayers with income of $10 million or more paid over a third (35.7%) of the total NIIT collected in 2018. These individuals paid $518,845 in NIIT on average in 2018. **Table 1** also shows that those making between $200,000 and $500,000 accounted for the majority of taxpayers (68.8%) subject to the 3.8% tax. The average amount of NIIT paid by these taxpayers was $1,108 in 2018. Across all taxpayers subject to the NIIT in 2018, the average amount of tax paid was $5,980.

Table 1. Distribution of Net Investment Income Tax, 2018

Adjusted Gross Income	Share of Returns with Tax	Share of NIIT Paid
Less than $100k	0.1%	0.0%
$100k under $200k	1.7%	0.1%
$200k under $500k	68.8%	12.8%
$500k under $1 million	19.5%	14.9%
$1 million under $2 million	6.2%	12.8%
$2 million under $5 million	2.6%	14.3%
$5 million under $10 million	0.6%	9.4%
$10 million or more	0.4%	35.7%
Total	**100%**	**100%**

Source: Internal Revenue Service, Statistics of Income, Table 3.3.

Policy Options

A number of options pertaining to the NIIT are available depending on the objective of policymakers. One option is to leave the tax in its current form. The following discusses possible modifications to the tax.

Eliminate the Tax

One option would be to eliminate the tax. This change would reduce the tax burden on investment, which, to the extent investment is lower than it otherwise would be, could increase investment. Eliminating the tax would also reduce complexity in the tax code.

Repealing the tax would reduce federal tax revenues. According to previously mentioned JCT estimates, repeal of the NITT would reduce revenues by approximately $27.5 billion in 2021. Eliminating the tax would also reduce the progressivity of the overall tax system.

Adjust the Tax Rate

Adjusting the NIIT rate could help to achieve certain policy goals. Lowering the rate would help to address concerns about the tax's impact on investment. Raising the tax rate would likely generate greater tax revenue and increase progressivity in the tax system. Adjusting the tax in either direction would not impact the administrative aspects of the tax, assuming no other changes were made. One issue in raising the tax rate is that it could increase the lock-in effect for capital gains (the incentive to hold on to assets rather than sell them), although there is disagreement about the size of the lock-in effect.

Adjust the Income Thresholds

As with adjusting the tax rate, adjusting the income thresholds could help policymakers achieve particular objectives. Lowering the income thresholds would result in more households being subject to the tax, and hence, more revenue. This change could also decrease progressivity in the tax code and increase complexity from the perspective of those who would be subject to the tax. Increasing the income thresholds would result in fewer households subject to the tax, and hence, less revenue. This would increase progressivity in the tax code, since it would concentrate the incidence on the highest-income taxpayers and reduce complexity for those taxpayers now no longer subject to the tax.

Index for Inflation

The NIIT income thresholds are not indexed for inflation. As a result, more taxpayers can be subject to tax over time regardless if their real (inflation-adjusted) income has increased, or increased significantly. Indexing the income thresholds would address this issue. Other components of the tax code, such as the ordinary income tax brackets and the standard deduction, are indexed for inflation.

Expand the Measure of Income Subject to Tax

The owners of limited partnerships and S corporations—two forms of business known as "pass-throughs" and that are not subject to the corporate income tax—may be able to avoid the NIIT if they are actively involved in the business. Such owners may also be able to avoid the additional 0.9% Medicare tax that applies to wages and self-employment income above $200,000 for single filers and $250,000 for married individuals filing jointly. These thresholds are the same ones that apply to the NIIT.

In its most recent Options for Reducing the Deficit, the Congressional Budget Office (CBO) presented the option of subjecting the income of active limited partnership and S corporation owners that is not already subject to the additional 0.9% Medicare tax to the NIIT. The JCT estimates provided to the CBO suggest this change could raise $209.8 billion over 10 years.

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